

# Review of Sanctions in Corporate Law

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ISBN 0 642 74363 0

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## CONSULTATION PROCESS

This paper forms the basis for the review of civil and criminal sanctions in the *Corporations Act 2001* and the *Australian Securities and Investments Commission Act 2001* (corporate law). It aims to raise issues and canvass possible options for reform. Interested parties are invited to make written submissions that address, but need not be limited by, the issues raised in this paper including supporting information such as examples and evidence where relevant.

Submissions may be lodged electronically, by post or facsimile. Please direct submissions to:

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The closing date for submissions is 1 June 2007. Submissions may appear on the Treasury website, [www.treasury.gov.au](http://www.treasury.gov.au) (subject to any claims for confidentiality).

It will be assumed that submissions are not confidential and may be made publicly available. If you would like your submission, or any part of it, to be treated as 'confidential', please indicate this clearly. A request made under the *Freedom of Information Act 1982* (Cth) for a submission marked confidential to be made available will be determined in accordance with that Act.



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## EXECUTIVE SUMMARY

Corporate wrongdoing has the potential to impact on the efficiency and development of the economy, and has repercussions that may be felt across the community. As such, it is important that corporate law provides appropriate incentives for compliance.

Regulatory theory suggests that regulatory agencies are best able to secure compliance when they have the capacity to impose significant sanctions for misconduct in situations where this is warranted. It is also important that regulators have access to a hierarchy of lesser sanctions for less serious breaches.

Australia's corporate law provides the Australian Securities and Investments Commission (ASIC) with a wide variety of enforcement options. These include criminal sanctions, civil sanctions, disqualification and enforceable undertakings. These sanctions supplement a broader system of private redress against corporate misconduct, including derivative actions and class actions.

Australia's regulatory system is highly regarded internationally and the Government is committed to ensuring that ASIC is well resourced to maintain enforcement of the law. The overview of the ASIC's enforcement outcomes below demonstrates the sound enforcement record in this area.

	2005-06	2004-05	2003-04	2002-03	2001-02
Criminals gaoled	17	27	28	29	19
Litigation concluded	386	193	220	222	205
Per cent successful litigation	94%	94%	93%	94%	92%
Recoveries, costs compensation, fines or assets frozen	\$215m	\$123m	\$121m	\$123m	\$110m

The recent Taskforce on Reducing Regulatory Burden on Business recommended that the Government review penalties for breaches of directors' duties to ensure that they strike an appropriate balance between promoting good behaviour and ensuring business is willing to take sensible commercial risks. This reflected a concern that exposure to sanctions could engender an overly conservative approach by some directors to the detriment of business development. The relevant extract from the Taskforce's report is provided as an attachment to this document.

This review seeks to establish the extent to which sanctions under corporate law may be unduly influencing business decisions. It invites submissions from the community about situations where sanctions (or the absence of sanctions) under corporate law influenced a decision to engage in a certain business activity.

The review then identifies two types of reform that could be considered to address concerns about sanctions that may be imposed under corporate law.

The first group of reforms would expand the types of sanctions imposed for breaches of corporate law. The review seeks comments on whether there could be greater use of civil and administrative sanctions for certain types of offences. Specific issues are raised about strict liability criminal offences, imprisonment, procedures for civil penalty proceedings, and the magnitude of civil penalties.

The second group of reforms would clarify the circumstances in which a sanction could be imposed under corporate law. The review seeks comment on whether a consistent defence should be introduced for company officers. Specific issues are raised about the test of good faith, reliance on advice, the obligation to keep financial records, the drafting of offence provisions generally, and market manipulation.

The Government has not reached a position on these issues, but will consider them in light of the comments received.

The closing date for submissions is 1 June 2007. After the closing date, the Treasury will provide preliminary advice to the Treasurer, who will identify issues warranting further development. An advisory group will be established to assist in preparing a proposals paper, for consideration by the Treasurer in November 2007.

## Summary of consultation issues

Topic	Consultation issue
<b>1. Responsive regulation and responsible risk taking</b>	
Responsive regulation and responsible risk taking	<p>Are you aware of any situations where the prospect of potential sanctions under corporate law influenced a decision about whether to engage in a certain business activity? If so:</p> <ul style="list-style-type: none"> <li>▪ Which provision gave rise to the concern?</li> <li>▪ Was this due to the prospect of imprisonment or personal liability for a fine or compensation order, for something you considered to be out of your control?</li> <li>▪ Was this due to uncertainty about the operation of the law in a particular fact scenario?</li> </ul> <p>Are you aware of any situation where the absence of sufficient sanctions under corporate law influenced a decision about whether to engage in a certain business activity?</p> <p>Do you consider that the regime for corporate regulation in Australia deters responsible risk-taking more or less than is the case in other comparable jurisdictions?</p> <p>Are there areas that you consider the law has gone to far to protect investors, at the cost of entrepreneurship? Are there areas where the law has not gone far enough?</p>
<b>2. Criminal, civil and administrative sanctions in corporate law</b>	
Criminal sanctions	<p>Should criminal sanctions only apply where there is an effect or potential effect on the integrity of the market that warrants the severest condemnation or punishment, and/or where the market would expect an element of retribution, and/or where a breach is intentional or reckless?</p> <p>Should strict liability offences be limited to situations where:</p> <ul style="list-style-type: none"> <li>▪ the offence is not punishable by imprisonment and is punishable by a fine of up to 60 penalty units for an individual (300 for a body corporate);</li> <li>▪ the punishment of offences not involving fault is likely to significantly enhance the effectiveness of the enforcement regime in deterring offences; or</li> <li>▪ there are legitimate grounds for penalising persons lacking 'fault', for example because they will be placed on notice to guard against the possibility of any contravention?</li> </ul> <p>Should imprisonment only be retained as a penalty for serious criminal offences with the maximum term being at least six months?</p>

Topic	Consultation issue
<b>2. Criminal, civil and administrative sanctions in corporate law (continued)</b>	
Civil sanctions	<p>Should greater use be made of civil sanctions for breaches of corporate law?</p> <p>If so, should civil sanctions apply:</p> <ul style="list-style-type: none"> <li>▪ Where misconduct affects or potentially affects the integrity of the market, but there is an absence of intention in the conduct that makes the offence less egregious than an offence attracting a criminal sanction?</li> <li>▪ Where strict liability applies to all elements of an offence?</li> </ul> <p>Should there be an increase, or a reduction, in the amount of civil pecuniary penalties? If maximum pecuniary penalties are thought to be inadequate, would alternative options like those proposed for the <i>Trade Practices Act 1974</i> be appropriate in corporate law?</p> <p>Should the rules of procedure to be adopted by the courts in civil proceedings under the Corporations Act be more clearly defined in the Act?</p> <p>If rules were to be included in the Act, should they be the same as the rules followed in civil remedial actions or should they be some type of hybrid between criminal and civil procedure?</p> <p>Are there any particular privileges available under the criminal law that should be abrogated in civil actions?</p>
Administrative sanctions	<p>Do you agree that there is scope in corporate law for administrative sanctions to apply to breaches of low level record keeping and reporting provisions? Are there any types of misconduct within these low level offences that administrative sanctions should not apply to?</p>
<b>3. Better defining the contravention</b>	
General protection for directors	<p>Do you consider that the introduction of a general defence would improve the balance between discouraging undesirable conduct and promoting responsible risk taking?</p> <p>Do you consider that the proposed elements of the general defence are correct?</p> <ul style="list-style-type: none"> <li>▪ Are there any particular concepts in the general defence that may require further consideration or elaboration?</li> </ul> <p>Should the general defence apply to the 'core' duties in sections 180-183 and section 588G?</p> <ul style="list-style-type: none"> <li>▪ Are there any adverse consequences that may result from a general protection applying to the duties of use of position (section 182) and use of information (section 183)?</li> <li>▪ Would an extension of the general defence to the insolvent trading provisions encourage insolvent trading? Would an extension be to the detriment of creditors?</li> <li>▪ If the general defence is applied to the duty to exercise care and diligence (section 180) is there a need to clarify its interaction with the business judgement rule in subsection 180(2)?</li> <li>▪ If the general defence is applied to the insolvent trading provisions, is there a need to clarify its interaction with the existing defences?</li> </ul> <p>Should the general defence apply to those strict liability offences that are intended to protect shareholder interests?</p> <p>The business judgment rule in subsection 180(2) also applies to equivalent duties at common law and in equity. Should a general defence also apply as a defence to actions brought in relation to equivalent duties at common law or equity?</p>
Inconsistent approach between sections 180 and 181	<p>Should the lack of symmetry between sections 180 and 181 on what constitutes acting 'in the best interests of the corporation' be addressed by introducing the concept of 'rational belief' to section 181?</p>
Review of section 189	<p>Does the requirement to make an independent assessment of information or advice received, place too high a burden on directors?</p> <p>Is the original formulation of subparagraph 189 (b)(ii) preferable to the current formulation?</p>
The obligation to keep financial records	<p>Does the penalty for breach of section 286 provide an adequate deterrent?</p> <p>Are there alternatives to pecuniary penalties that could apply to a contravention of section 286?</p>

Topic	Consultation issue
<b>3. Better defining the contravention (continued)</b>	
Drafting of offence provisions	<p>Would specifying the maximum penalty within a provision in the Corporations Act improve understanding and clarity of offence provisions?</p> <p>Are there any provisions in corporate law where confusion is arising in the application of the provision because of inconsistency with requirements under the Criminal Code?</p> <p>Are there any provisions in corporate law where confusion is arising because of 'reasonable excuse' defences, or other defences that replicate defences under the Criminal Code?</p>
Market manipulation and subsection 1041B(2)	<p>Should section 1041B be amended to clarify the circumstances in which someone will be criminally liable, as a result of the combined effects of section 5.6 of the Criminal Code and the deeming provision in subsection 1041B(2) of the Corporations Act?</p> <p>If so, would it be appropriate to amend the section so a person is criminally liable:</p> <ul style="list-style-type: none"> <li>▪ if that person intended or was aware or was reckless that matched trades or a trade without change of beneficial ownership would occur; or</li> <li>▪ if that person intended or was aware or reckless that a false or misleading appearance would occur?</li> </ul> <p>Should there be a change to the circumstances in which criminal liability is incurred as a result of the application of subsection 1041B(2), so that a person is criminally liable without needing to prove any knowledge, intent or recklessness, but has a defence if it is proved that the purpose or purposes for which the person did the act was not, or did not include, the purpose of creating a false or misleading appearance of active trading in particular financial products on a financial market?</p> <p>Should there be a change to the circumstances in which civil liability is incurred as a result of the application of subsection 1041B(2)?</p> <p>If so, would it be appropriate that civil liability is incurred:</p> <ul style="list-style-type: none"> <li>▪ if a person intended or was aware or reckless that matched trades or a trade without change of beneficial ownership would occur; or</li> <li>▪ if a person intended or was aware or reckless that a false or misleading appearance would occur; or</li> <li>▪ without needing to prove any mental element, as at present, but allowing a defence if it is proved that the purpose or purposes for which the person did the act was not, or did not include, the purpose of creating a false or misleading appearance of active trading in particular financial products on a financial market; or</li> <li>▪ as now, but giving the Court the discretion not to make a declaration of contravention where a person has contravened section 1041B?</li> </ul>

## INTRODUCTION

1. This review is being conducted with a view to simplifying regulation and making it more effective. Business regulation, particularly the amount and quality of that regulation, has a significant impact on the competitiveness of Australian businesses and the economy as a whole.
2. The *Corporations Act 2001* and the *Australian Securities and Investments Commission Act 2001* (corporate law) provide the framework for regulation of companies and financial services and markets. Recognising the important role played by the corporate entity in entrepreneurial, business and investment activity, the Government has sought to develop a framework that promotes informed participation in markets without introducing unwarranted costs or inflexibility.
3. An important part of this framework is the suite of sanctions that may be imposed where there has been a contravention.<sup>1</sup> Ideally, these sanctions should:
  - discourage undesirable behaviour that might reduce the efficiency and development of the economy;
  - facilitate responsible risk taking and innovation; and
  - provide the regulator with the flexibility to tailor a regulatory response to the circumstances of a breach.
4. This review invites comments on the effect that the current system of sanctions in corporate law has on commercial decision making. Responses will assist in developing an improved understanding of the benefits of different regulatory approaches, and inform an assessment of whether the current regulatory approach continues to strike the right balance. The review also canvasses two broad approaches to reform in this area, if it is considered that reform is required.
5. The first approach is to re-examine the principles guiding the use of different types of sanctions. This part of the review draws on recent recommendations of the Australian Law Reform Commission (ALRC), which identify principles for use by legislators when considering whether a particular wrongdoing should be classified in law as criminal or non-criminal.<sup>2</sup> Similar issues are currently being examined in the United Kingdom, with the Better Regulation Executive seeking to articulate a set of principles relevant to the operation of criminal, civil and administrative sanctions generally.<sup>3</sup> Responses will inform an assessment of how corporate law offences should be categorised.

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1 The aim of the paper is to review civil and criminal sanctions in corporate law. The scope of the review does not extend to civil remedies, for example probation orders, community service orders and publicity orders that are also available under corporate law.

2 The Australian Law Reform Commission: Discussion Paper 65: *Securing Compliance: Civil and Administrative Penalties in Australian Federal Regulation*: Chapter 2 at paragraph 2.8.

3 Cabinet Office, Better Regulation Executive, *Regulatory Justice: Sanctioning in a post-Hampton World*, available at [www.cabinetoffice.gov.uk](http://www.cabinetoffice.gov.uk).

6. The second approach is to refine the underlying offence provisions to more clearly identify the circumstances in which a sanction may be imposed. This section includes a number of discrete reform proposals put to Government in recent years, including the introduction of consistent defences for directors and clarification of the operation of the prohibition on market manipulation.
7. The consultation process invites interested parties to make written submissions by 1 June 2007. A preliminary report on the outcomes of the review will be provided to the Treasurer in August 2007. An advisory group will be established to provide detailed advice on specific issues identified by the Treasurer as warranting further consideration. A proposals paper will be provided to the Treasurer in November 2007. Further consultation will occur in relation to any substantive changes to corporate law arising from the review.

# CHAPTER 1: RESPONSIVE REGULATION AND RESPONSIBLE RISK TAKING

## Introduction

- 1.1 Corporate law provides a legal framework to facilitate the efficient allocation of capital to the most productive ventures, and the subsequent management of that capital by specialist managers in the interests of members. It seeks to promote standards of behaviour over and above that required under laws of general application, such as criminal law.
- 1.2 Corporate wrongdoing has the potential to impact on the efficiency and development of the economy, and has repercussions that may be felt by the broader community including employees, creditors, customers and shareholders. In addition, it has been suggested that corporate offences have a tendency to 'erode the moral base of the law and provide an opportunity for other offenders to justify their misconduct'.<sup>1</sup> For these reasons, it is important that corporate law provides appropriate incentives for compliance.
- 1.3 Corporate law currently provides a range of criminal, civil penalty and civil sanctions, which may apply to individuals or corporations.
- 1.4 In respect of criminal breaches of the law, sanctions include fines of up to \$220,000 and imprisonment for up to 10 years. Minor offences under the *Corporations Act 2001* (Corporations Act) can incur a fine called a penalty notice, payment of which precludes criminal proceedings.
- 1.5 Civil penalties of up to \$200,000 (or \$1 million for a body corporate in relation to a breach of the financial services civil penalty provisions) and compensation orders can be imposed in respect of a contravention of a civil penalty provision, including breach of directors' duties, insolvent trading and continuous disclosure breaches.
- 1.6 A person may also be banned from managing corporations or providing financial services where they have contravened a criminal provision or civil penalty provision, and in other circumstances.
- 1.7 ASIC may also accept enforceable undertakings given by a person in respect of any matter in relation to which ASIC has a function or power. If a person breaches an enforceable undertaking, ASIC can apply to the court to seek orders to compel compliance with that undertaking without having to establish a contravention of the underlying legislation originally the subject of the enforceable undertaking.

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1 His Honour, Justice Finkelstein, *Australian Securities and Investments Commission v Vizard* [2005] FCA 1037 (28 July 2005).

- 1.8 A system of infringement notices also operates under the Corporations Act. These notices allow ASIC additional options to civil action or prosecution to address less serious breaches of the Corporations Act continuous disclosure provisions. Payment of the penalty set out in the notice, and the disclosure of information considered to have been withheld, precludes any further civil penalty or criminal proceedings.<sup>2</sup>
- 1.9 These regulatory sanctions supplement a broader system of private redress against company misconduct. For example, shareholders may group together to enforce their legal rights through a shareholder class action or bring a derivative action on behalf of the company against persons who have caused loss to the company. Shareholders can also influence the outcome of shareholder votes by naming a corporate entity as their proxy in shareholder meetings.

### An overview of regulatory theory<sup>3</sup>

- 1.10 One of the common debates in regulatory theory is between those who believe that individuals and corporations will comply with rules and regulations only when confronted with sanctions and penalties, and those who believe that persuasion and cooperation is more effective in securing compliance with the law. These two alternate approaches to regulation have been termed the 'deterrence' and the 'accommodative' models of regulation.

### The deterrence model

- 1.11 For those who advocate a purely deterrence model, individuals and corporations are seen to be 'rational actors', who are motivated entirely by profit-seeking. They carefully assess opportunities and risks, and will breach the law if the expected cost, calculated by reference to the anticipated fine and probability of being caught, are small in relation to the expected benefits in terms of profits to be made through non-compliance. Advocates of this model therefore consider that harsh sanctions and penalties are necessary to ensure compliance.
- 1.12 The deterrence model has been criticised on a number of grounds. One criticism has been that it does not satisfactorily explain the high levels of voluntary compliance observed in many situations. If people were simply 'rational actors' motivated purely by self-interest, one would expect that compliance with rules and regulations would be significantly less prevalent than what has been observed. In the 1980s, therefore, many researchers began to question the value of deterrence in regulating behaviour. Regulatory scholars began to focus their attention on researching reasons for compliance, and began to realise the importance of persuasion and cooperation as a regulatory tool.

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2 The infringement notice provisions are the subject a separate review by Government. A discussion paper is available at [www.treasury.gov.au](http://www.treasury.gov.au).

3 The overview of regulatory theory is reproduced in large part from the ANU's Centre for Tax System Integrity, Working Paper 45 of November 2004: *Moving towards a more effective model of regulatory enforcement in the Australian Taxation Office*.

## The accommodative model

- 1.13 The accommodative model views corporations and individuals not as ‘rational actors’ but as ‘social actors’, who are ordinarily inclined to comply with the law, partly because of belief in the rule of law, and partly as a matter of long-term self-interest. Regulatory agencies adopting the accommodative model tend to be more orientated toward seeking compliance outcomes through cooperation rather than by coercion, and prefer to see themselves as consultants rather than as strict law enforcers. These agencies are more likely to give second chances and advice about how to comply. They may also agree to ignore one violation in return for a correction of another violation.

## Disadvantages of the deterrence and accommodative models

- 1.14 Each model has major disadvantages if regulators choose to adopt one exclusively. It has been shown that a predominantly punitive policy fosters resistance to regulation and may produce a culture that facilitates the sharing of knowledge about methods of legal resistance and counter attack.<sup>4</sup> It has been suggested that laws that promote a ‘tick the box’ approach to compliance may have the effect of weakening the ethical sinews of society by absolving participants of any responsibility for choosing to act in a manner that is right. An unintended consequence of a regulatory system designed to ensure that people cannot choose to do what is wrong is that they can no longer choose to do what is right. They no longer choose at all, they merely comply.<sup>5</sup> Another concern is that if regulators adopt a purely punitive method of regulating, whereby they assume that individuals are solely self-interested and motivated by financial gain, this may be perceived as unreasonable and will dissipate the will of well-intentioned individuals to comply. In addition to the negative psychological effect of an undue focus on deterrence, punishment is often time consuming and expensive.
- 1.15 Adopting a purely accommodative model of regulation, which assumes all individuals are honest, would be naïve. This regulatory style fails to recognise that there are individuals who may not be honest and who will take advantage of being presumed to be so.<sup>6</sup> There are a number of recent examples of conduct by corporate actors in Australia that confirm that some people will intentionally breach rules to secure an economic benefit.

## Responsive regulation

- 1.16 A regulatory system premised solely on the deterrence or on the accommodative model is not desirable. John Braithwaite<sup>7</sup> has argued that sound regulatory enforcement requires that regulators understand that sometimes those being regulated are motivated solely by making money and sometimes they are motivated by a sense of social responsibility. In other words, a firm may be a responsible citizen and social actor today but a rational actor calculating costs and benefits tomorrow. Braithwaite

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4 *ibid.*, p 3.

5 This particular concern was raised by the St James Ethics Centre in their submission to the Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Corporate Social Responsibility.

6 *ibid.*, p 5.

7 Braithwaite, J 1985 *To Punish or Persuade: Enforcement of Coal Mine Safety*. Albany: State University of New York Press.

has therefore rejected a regulatory strategy based totally on persuasion and cooperation or a regulatory strategy based totally on deterrence through punishment.

- 1.17 Braithwaite and co-author Ian Ayres argued in 1992 that the time had come to depart from what they described as ‘a long history of barren disputation’ between those advocating accommodative and deterrence models of regulatory theory. They proposed a convergence of the two approaches. This theoretical approach to regulation is widely known as ‘responsive regulation’, and it is now being recognised that regulatory models that are best at achieving their goals are those that strike a sophisticated and dynamic balance between the deterrence and accommodative models of regulation.
- 1.18 The basic question for responsive regulation is not whether to punish or persuade, but *when* to punish and *when* to persuade. A key concept of the Ayres and Braithwaite model is that, although the regulator should have access to severe punishments, they should rarely need to use them in practice if they ensure that it is economically rational for the regulated to cooperate. Where breaches occur, the initial response should be to persuade and educate the transgressor on appropriate behaviour – this promotes self-regulation and the wish to preserve reputation. However, once persuasion has failed, there should be punishment and the question then becomes the type of penalty applicable to a particular wrongdoing.<sup>8</sup>

### The enforcement pyramid

- 1.19 Ayres and Braithwaite argue that regulatory agencies are best able to secure compliance when they are ‘benign big guns’.<sup>9</sup> That is, they will be more able to speak softly when they carry big sticks and, crucially, a hierarchy of lesser sanctions. The bigger and more various the sticks, the greater the success regulators will achieve by speaking softly. Ayres and Braithwaite developed a graphic representation of their model known as the ‘enforcement pyramid’.
- 1.20 Under this model, if a regulator can plausibly threaten to meet non-compliance by moving up the pyramid, then most of the regulator’s work can be done effectively at the bottom of the pyramid. At the base of the pyramid are methods of education and persuasion. Incapacitation is at the apex of the pyramid and can be achieved through both civil and criminal measures. Civil pecuniary penalties should inhabit the middle to upper levels of the pyramid and, in ideal conditions, will be closely integrated with other regulatory sanctions.

### Application of the pyramid in corporate law – directors’ duties

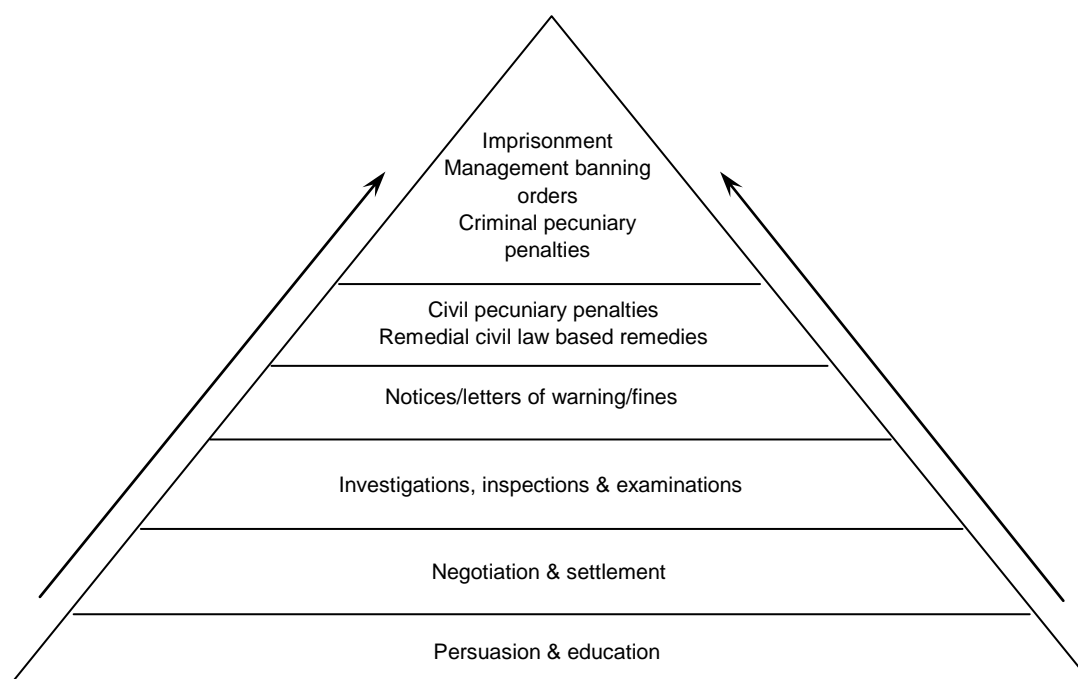
- 1.21 The application of the pyramid in corporate law can be demonstrated through an examination of the obligations commonly known as ‘directors’ duties’.

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8 The Australian Law Reform Commission, *Principled Regulation Report: Federal Civil and Administrative Penalties in Australia*, December 2002, paragraphs 3.34, 3.35.

9 Braithwaite, J Ayres, *I Responsive Regulations: Transcending the Deregulation Debate*, Oxford University Press 1992.

- 1.22 As with other agency relationships, the separation of ownership and control in the corporation introduces agency problems. The imposition of directors' duties addresses a concern that market forces may not provide sufficient incentives for company officers to act in a manner that best promotes the interests of the company (and indirectly its members). Unless this higher standard of conduct was required of directors and company officers, an inefficiently low level of capital would be made available to fund corporate activity.
- 1.23 The Corporations Act imposes a range of general and specific obligations on directors and other company officers. The main aim of these provisions is to ensure that directors and other company officers are loyal to, and act in the interest of, the company. Some reflect standards of conduct imposed under the common law, for example, the standard of care and diligence. Others are more 'mechanical' in their nature and impose specific requirements such as the duty to keep financial records.
- 1.24 An overview of current compliance and enforcement tools used in corporate law to regulate directors' duties is illustrated below. While this pyramid shows the main options available to the regulator to secure compliance with directors' duties, it is not intended to represent a comprehensive list of the tools.



### Persuasion and education

- 1.25 Options may include education and advice programmes aimed at familiarising new and existing members of the regulated population with their legal obligations. For example, information is provided by ASIC to all new directors and secretaries outlining relevant obligations under the Corporations Act. Other tools utilised by ASIC include media releases to encourage awareness of statutory obligations and improve compliance levels.

## Negotiation and settlement

1.26 These options are an alternative to launching court proceedings. For example, ASIC has the power to accept an enforceable undertaking from a person in connection with a matter they have the power to investigate.<sup>10</sup>

## Investigations, inspections and examinations

1.27 ASIC has a number of options available to it including:

- conducting investigations that it believes are expedient for the due administration of corporate law;<sup>11</sup>
- requiring a person to provide reasonable assistance or appear before an ASIC officer to answer questions on oath where it believes or suspects that the person can assist with an investigation;<sup>12</sup> and
- inspecting books in a number of circumstances, including requiring a person on notice to produce specified books.<sup>13</sup>

## Injunctive powers

1.28 The court has discretion to grant an injunction restraining a person from engaging in conduct that contravenes the Corporations Act.<sup>14</sup> Where an application is made under subsection 1324(1), the court may grant an interim injunction restraining particular conduct before considering the application.<sup>15</sup> This allows an applicant to speedily obtain an order with the merits of the case to be decided at a later hearing. As an alternative to an injunction, the court may make an order for damages.<sup>16</sup>

## Freezing funds

1.29 The court may make orders freezing the property of a person where there is an investigation being carried out by ASIC into conduct that contravenes or may contravene the Corporations Act.<sup>17</sup> The freezing of the property is to benefit a person who may bring an action based on a breach of the legislation by preserving property against which the judgement may be enforced.

## Civil sanctions

1.30 Where a director contravenes a civil offence provision in the Corporations Act, ASIC may initiate civil proceedings by applying to the court for a declaration of the contravention, a pecuniary penalty order of up to \$200,000 (where the contravention is serious or materially prejudices the corporation's ability to pay its creditors)<sup>18</sup> or a compensation order.<sup>19</sup> Compensation orders may involve considerable sums of money. For example, ASIC is seeking compensation of \$93 million from former One.Tel

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10 *Australian Securities and Investments Commission Act 2001*, section 93A.

11 *Australian Securities and Investments Commission Act 2001*, Part 3, Division 1.

12 *Australian Securities and Investments Commission Act 2001*, Part 3, Division 2.

13 *Australian Securities and Investments Commission Act 2001*, Part 3, Division 3.

14 *Corporations Act 2001*, subsection 1324(1). An application for an injunction under subsection 1324(1) may be made either by ASIC or by a person whose interests have been or would be affected by the conduct.

15 *Corporations Act 2001*, subsection 1324(4).

16 *Corporations Act 2001*, subsection 1324(10).

17 *Corporations Act 2001*, subsection 1323(1).

18 *Corporations Act 2001*, section 1317G.

19 *Corporations Act 2001*, subsection 1317J(1).

Limited directors for the reduction in value of the company over a period of approximately eight weeks from 30 March 2001 to 29 May 2001, being the period during which One.Tel continued to trade, because of the alleged failure of the defendants to properly discharge their duties.<sup>20</sup>

### Banning orders

- 1.31 A director may be automatically banned from managing a corporation for a period of five years if they are convicted of certain offences.<sup>21</sup> On application by ASIC, the period of disqualification can be extended by up to an additional 15 years.<sup>22</sup> Banning may also occur on application by ASIC to the court where a director has contravened a civil penalty provision and the court believes the disqualification is appropriate.<sup>23</sup>

### Criminal sanctions

- 1.32 The maximum penalty for a contravention of a directors' duty provision is 2,000 penalty units (\$220,000), or imprisonment for five years, or both. Criminal proceedings may be started against a person even though a civil penalty order has been made against that person – although the rights of the defendant are protected by section 1317Q which makes evidence previously given in civil proceedings inadmissible in a prosecution for a criminal offence involving substantially similar conduct.

### ASIC enforcement performance

- 1.33 Australia's corporate regulator, ASIC, is well resourced to administer corporate law. Funding for ASIC has increased by 58 per cent above CPI since 1995-96, from \$128.1 million in 1995-96 to a budgeted \$265.2 million in 2006-07 (appropriation receipts). In 2005-06, ASIC succeeded in 94 per cent of litigation that it instigated.
- 1.34 In the 2005-06 financial year, ASIC had 27 criminals convicted (including 17 gaoled), completed 102 civil proceedings, obtaining \$144 million in recoveries, costs, compensation and fines, with more than \$71 million in assets frozen. ASIC also commenced 195 criminal, civil or administrative proceedings against 391 people or companies.
- 1.35 Some 44 directors were banned from managing corporations for a total of 195 years. ASIC also acted against 102 illegal fund raising schemes involving some 5,000 investors.

### Responsive regulation and responsible risk taking

- 1.36 While the responsive regulation model highlights the need for resort to severe punishments in some circumstances, in the context of corporate law this must be balanced against the potential for severe penalties to have a 'freezing effect' on responsible risk taking and commercial decision making.

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20 Source: ASIC Media Release 04-119.

21 *Corporations Act 2001*, subsection 206B(1).

22 *Corporations Act 2001*, section 206BA.

23 *Corporations Act 2001*, section 206C.

1.37 The policy balance that regulation in this area must address has been described as follows:

The objective of a legal rule is to deter certain undesirable behaviour without simultaneously deterring (too much) desirable behaviour. Rules should minimise the sum of the losses from: (a) undesirable behaviour that the rules permit, (b) desirable behaviour that the laws deter, and (c) the costs of enforcement. The legal system balances these competing objectives through the choice of sanctions as well as through the choice of substantive doctrines.<sup>24</sup>

1.38 In its recent assessment of business regulation, the Taskforce on Reducing Regulatory Burden on Business (the Banks Taskforce)<sup>25</sup> reported that comments it had received indicated that the magnitude of penalties attaching to breaches of regulation have been a major driver of a regulated entity's approach to managing risks. For example, business groups noted that the personal liability attaching to a number of directors' duties had led to a very conservative approach by some directors to the detriment of business decision making. The Taskforce cautioned that:

A risk-averse approach by business may limit their willingness to adopt innovative approaches in developing products and meeting new challenges. It would also be reflected in an overly cautious approach to compliance such as in product disclosure statements. This would undermine the overall efficiency and dynamism of the economy.<sup>26</sup>

1.39 It is difficult to empirically determine the extent to which legal frameworks influence the appetite for risk of company officers. However, if corporate law is engendering an overly conservative approach to business decision making, this could discourage investment in activities that would best advance the interests of the company. Such a distortion may have implications for longer term productivity and economic growth.

1.40 The Banks Taskforce recommended a review of the sanctions for breaches of directors' duties. While this area of the law is of particular importance as it provides a framework for business decisions taken by all of Australia's 1.4 million companies, it is also important to ensure that there are no unintended economic consequences arising out of the sanctions provided in other areas of corporate law.

1.41 The following sections identify two possible approaches to addressing concerns that are discussed above. Section 2 examines options to reform the sanctions applying to breaches of corporate law. Section 3 examines options to improve certainty about the operation of the substantive provisions that identify the circumstances in which a sanction may be imposed. Both types of reforms will be considered in light of any evidence that the current regulatory framework is unduly discouraging responsible risk-taking.

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24 The Economic Structure of Corporate Law, Easterbrook, FH and Fischel, DR Harvard University Press, 1996, p316.

25 Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business, January 2006.

26 Rethinking Regulation: Report of the Taskforce on Reducing Regulatory Burdens on Business, January 2006 at p 90.

### Consultation issues

Are you aware of any situations where the prospect of potential sanctions under corporate law influenced a decision about whether to engage in a certain business activity? If so:

- Which provision gave rise to the concern?
- Was this due to the prospect of imprisonment or personal liability for a fine or compensation order, for something you considered to be out of your control?
- Was this due to uncertainty about the operation of the law in a particular fact scenario?

Are you aware of any situation where the absence of sufficient sanctions under corporate law influenced a decision about whether to engage in a certain business activity?

Do you consider that the regime for corporate regulation in Australia deters responsible risk-taking more or less than is the case in other comparable jurisdictions?

Are there areas that you consider the law has gone to far to protect investors, at the cost of entrepreneurship? Are there areas where the law has not gone far enough?



## CHAPTER 2: CRIMINAL, CIVIL AND ADMINISTRATIVE SANCTIONS IN CORPORATE LAW

### Introduction

- 2.1 The discussion of the various theories of regulation in Chapter 1 touched on the importance of a balanced approach between coercive measures and cooperative measures to achieve effective regulation. Application of the model of 'responsive regulation' recognises that education and persuasion will not be successful in every situation. On some occasions a regulator will need to take enforcement action and this raises the issue of the type of sanction that will apply to a particular breach.
- 2.2 In determining the type of sanction appropriate to particular misconduct, it is necessary to distinguish the terminology used to describe the procedure by which a penalty is imposed, from the conduct that it seeks to address. Sanctions themselves are not inherently criminal, civil or administrative in nature, but are commonly referred to as such because of the procedure followed in court, or whether the court is involved at all.<sup>1</sup>
- 2.3 The current design of offence provisions in corporate law is for criminal sanctions to be used as a 'default' option, with the alternative of civil procedures applying in a limited number of situations where it may be practically difficult to prove all elements of the criminal offence. This heavy emphasis on criminal sanctions may not be the most effective means of achieving optimum compliance with the law. It is arguably inconsistent with the recommendation of the Australian Law Reform Commission (ALRC) in its Principled Regulation Report that caution should be exercised in extending the criminal law into regulatory areas unless the conduct that is being proscribed clearly merits the moral and social censure and stigma that attaches to conduct regarded as criminal.<sup>2</sup>

### Criminal sanctions in corporate law

#### Rationale for the use of criminal sanctions generally

- 2.4 Traditionally, the key characteristic of a crime, as opposed to other forms of prohibited behaviour, is the repugnance attached to the act which invokes social censure and shame.<sup>3</sup>
- 2.5 Established views about the type of behaviour that should be subject to criminal sanctions focus on the seriousness of the wrongdoing. For example, Ashworth, argues that criminal sanctions should be:

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1 The Australian Law Reform Commission, Principled Regulation Report: *Federal Civil and Administrative Penalties in Australia*, December 2002, at paragraph 2.2.  
2 *ibid.*, at paragraph 3.110.  
3 *ibid.*, at paragraph 2.10.

- used only to censure people for substantial wrongdoing;
- enforced with respect for equal treatment and proportionality; and
- proportionate to the seriousness of the wrongdoing.<sup>4</sup>

2.6 *A Guide to Framing Commonwealth Offences, Civil Penalties and Enforcement Powers*<sup>5</sup> (Guide to Penalties), lists a number of issues that should be considered when determining if a contravention of the law should have criminal consequences. These include:

- the nature of the conduct sought to be deterred;
- whether the conduct seriously harms other people; and
- whether the conduct in some way so seriously contravenes fundamental values as to be harmful to society.<sup>6</sup>

2.7 Other factors that need to be considered include the social stigma that accompanies a criminal conviction, particularly where the penalty imposed is imprisonment,<sup>7</sup> and the impact on a convicted person's reputation which may mean in a practical sense that person may not be able to run a business, hold certain public offices or travel to certain foreign countries.<sup>8</sup>

## Current status of criminal sanctions in corporate law

2.8 Criminal sanctions in corporate law are often directed at addressing behaviours that are outside the traditional scope of the criminal law – that is, misconduct that lacks those elements of causing serious harm to others or contravening society's fundamental values. This approach of applying criminal sanctions to punish a range of regulatory offences is not peculiar to corporate law, but is illustrative of a trend across the Commonwealth legislative sphere.<sup>9</sup>

2.9 The practice of applying criminal sanctions in corporate law to regulatory offences raises two concerns that are relevant to the issue of the suitability of criminal sanctions for certain types of conduct.

### Application of strict liability

2.10 Despite its status as a foundation principle of criminal law, the requirement of a 'mental' element for criminal offences has not always been applied in the creation of

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4 Ashworth, A. 'Is the Criminal Law a Lost Cause?' (2000) *Law Quarterly Review*, 116.

5 *A Guide to Framing Commonwealth Offences, Civil Penalties and Enforcement Powers*, Australian Government 2004. The guide is available at [www.ag.gov.au](http://www.ag.gov.au).

6 *ibid.*, at p 12.

7 *ibid.*, at p 13.

8 *ibid.*, at p 13.

9 As noted by the Australian Law Reform Commission in the Principled Regulation Report: *Federal Civil and Administrative Penalties in Australia*, December 2002, at paragraph 2.8., regulatory law concerns the way that Governments regulate private sector activity or otherwise intervene in the operation of different areas of society outside traditional criminal law.

offences in the regulatory sphere.<sup>10</sup> Where an offence is one of strict liability, the prosecuting authority bringing the action only has to show that the alleged act took place, removing the requirement to prove a guilty mind – for example, intent, knowledge or recklessness.<sup>11</sup>

- 2.11 The main argument in favour of the use of strict liability is its value in making prosecution of offenders more straightforward. This needs to be balanced with the problem that the application of strict liability does not allow differentiation between persons that intentionally flout the law and those that make their best efforts to comply. This can lead to resentment on the part of a person who is found guilty of a criminal offence without any element of moral culpability. Moreover, as criminal convictions increasingly become part of the business cycle, they may lose much of their moral stigma.
- 2.12 The Senate Standing Committee for the Scrutiny of Bills in its report, *Application of Absolute and Strict Liability Offences in Commonwealth Legislation*, has recommended that agencies should acknowledge that there may be areas where existing strict liability offences, or the way they are administered, may be unfair.<sup>12</sup>
- 2.13 The Guide to Penalties adopts a similar approach, stating that application of strict liability to all fault elements of an offence should only be considered appropriate where:
- the offence is not punishable by imprisonment and is punishable by a fine of up to 60 penalty units for an individual (300 for a body corporate);
  - the punishment of offences not involving fault is likely to significantly enhance the effectiveness of the enforcement regime in deterring offences; or
  - there are legitimate grounds for penalising persons lacking ‘fault’, for example, because they will be placed on notice to guard against the possibility of any contravention.<sup>13</sup>

### Imprisonment as a penalty

- 2.14 The second concern with the application of criminal sanctions for breaches of corporate law is the appropriate use of imprisonment as a penalty. Corporate law provides terms of imprisonment for a number of strict liability offences,<sup>14</sup> and imposes maximum terms of imprisonment that are less than six months duration in some cases.
- 2.15 The ALRC has stressed the importance of reserving imprisonment for the most serious offences, the primary value of imprisonment arising from its perception as the ultimate

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10 Brown, D and others, *Criminal Laws: Materials and Commentary on Criminal Laws and Process of New South Wales* (2001), The Federation Press, Sydney at p 357.

11 The *Criminal Code Act 1995* provides for four types of fault: intention, knowledge, recklessness and negligence. The Act also provides that strict liability is an alternative to fault. Some examples of the application of strict liability in the *Corporations Act 2001* are sections 448C, 448D and 471A.

12 Report 6/2002, *Application of Absolute and Strict liability Offences in Commonwealth Legislation*.

13 *A Guide to Framing Commonwealth Offences, Civil Penalties and Enforcement Powers*, Australian Government 2004, at paragraph 4.5.

14 *ibid.*

sanction.<sup>15</sup> The ALRC argues that for certain types of offences imprisonment should be removed as a sentencing option, especially where no systematic fraud is involved.<sup>16</sup>

- 2.16 The Senate Scrutiny of Bills Committee has been critical of the frequent use of imprisonment as a penalty for offences relating to the provision of information.<sup>17</sup> The Committee agreed with the ALRC's approach that imprisonment should only be retained for those offences or circumstances that Parliament considers to be sufficiently serious. In relation to offences such as failing to provide information, the Committee argued that imprisonment may be an appropriate sentencing option where an individual knowingly makes misleading statements for financial gain or prejudices a quasi-criminal investigation.<sup>18</sup>
- 2.17 Where imprisonment is considered an appropriate penalty for a Commonwealth offence, the Guide to Penalties recommends that a term of at least six months should be specified.<sup>19</sup> The reasoning for that approach is that it is not a meaningful option to allow a court to imprison someone for a period as short as a few weeks or months. Such a brief term is unlikely to indicate that the offence is a serious one, and if a longer term of imprisonment would never be justified a fine is likely to be more appropriate. Avoiding short maximum prison terms reinforces the message that imprisonment is reserved for serious offences, and also avoids the potential for burdening correctional systems with minor offenders.<sup>20</sup>

### Proposed status of criminal sanctions in corporate law

- 2.18 It is suggested that the use of criminal sanctions is reviewed, so that they no longer operate as the 'default' sanction for breaches of corporate law. Rather, criminal sanctions could be targeted to circumstances where their application is justified having consideration to the criteria discussed in paragraphs 2.4 to 2.7 above. An important element in the criteria is that behaviour attracting a criminal sanction should involve wrongdoing that is 'serious' or 'substantial'. In the corporate law context this could mean that the wrongdoing is intentional or repeated, or that it would have an effect or potential effect on the market that warrants the strongest deterrent or punishment, or that market participants would expect an element of retribution for the wrongdoing.
- 2.19 An example of the type of situation where criminal sanctions are considered to be warranted is the intentional or reckless breach of the 'directors' duty' to act in good faith and for a proper purpose. The requirement for intentional or reckless breach limits the scope of the provision to situations where there is a clear element of moral culpability. The potential for significant benefits from intentional misconduct in this area must be balanced with the most significant penalties. Moreover, breaches of this nature are likely to have a significant negative affect on confidence of a range of market participants, including shareholders and creditors.

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15 Law Reform Commission, Report no. 44, Sentencing, Australian Government 1988.

16 *ibid.*

17 Senate Scrutiny of Bills Committee, 'Application of Absolute and Strict Liability Offences in Commonwealth Legislation', Report 6/2002.

18 *ibid.*

19 A Guide to Framing Commonwealth Offences, Civil Penalties and Enforcement Powers, *loc cit.*

20 *ibid.*

- 2.20 The more targeted use of criminal sanctions would address concerns that some requirements under corporate law are procedural or mechanical in nature, and failure to carry them out should be enforced by means other than a criminal penalty. While it is important that these provisions are enforced, it may not be appropriate that they attract a criminal penalty.<sup>21</sup>
- 2.21 In this regard, it is also noted that the costs of enforcing and defending criminal offences are high. This suggests that alternatives (including civil and administrative sanctions) should be explored where this would not undermine the policy intent of the substantive provision. The proposed approach would also involve the removal of strict liability for criminal offences that fall outside the criteria discussed in paragraph 2.13 and the confinement of imprisonment as a punishment to situations where an offence is regarded as sufficiently serious to warrant a maximum term of imprisonment of six months or more.

### Magnitude of criminal penalties

- 2.22 On 23 February 2006, the Minister for Justice and Customs, Senator Chris Ellison, announced the Terms of Reference for a whole-of-government review of criminal penalties in Commonwealth legislation. This review involves all relevant Commonwealth agencies and is being coordinated by the Attorney-General's Department. The Terms of Reference are available on the Attorney-General's Department website.
- 2.23 The magnitude of criminal penalties under corporate law will be considered as part of this review.

### Civil sanctions in corporate law

#### Rationale for the use of civil sanctions generally

- 2.24 Whilst the aim of the criminal law is traditionally regarded as deterrence and punishment, civil law has traditionally focussed on private redress for wrongs that do not involve elements of public retribution or compensation.<sup>22</sup> In particular, civil remedies apply to conduct that has directly harmed an individual's interests.<sup>23</sup> In contrast, punitive civil sanctions, like criminal sanctions, are invoked by the state but follow court processes and procedures used in private civil actions. Use of civil sanctions may be considered, for example, where misconduct does not affect the integrity of the market or warrant the severest condemnation or punishment.
- 2.25 The primary purpose of civil sanctions is the same as criminal sanctions – that is deterrence and punishment. The contravention of a civil provision may be similar to a criminal offence (for example, breaches of directors' duties) and may involve the same

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21 Report of the Senate Standing Committee on Legal and Constitutional Affairs Report, *Social and Fiduciary Duties and Obligations of Company Directors* 1989 at paragraph 13.10.

22 *ibid.*, at paragraph 2.3.

23 *ibid.*, at paragraph 2.15.

or similar conduct, but the procedure by which the offender is sanctioned is based on civil court processes.<sup>24</sup>

2.26 Factors that distinguish criminal sanctions from civil sanctions include:

- the greater role of intent in the criminal law, with its emphasis on subjective awareness rather than objective reasonableness;
- the criminal law's focus on risk creation, rather than actual harm;
- its insistence on greater evidential certainty and lesser tolerance of procedural informality;
- its reliance on public enforcement, tempered by prosecutorial discretion; and
- its deliberate intent to inflict punishment in a manner that maximises stigma and censure.<sup>25</sup>

2.27 Civil penalties can be an important element in the enforcement pyramid as they may be sufficiently serious to act as a deterrent, if imposed at a high enough level, but do not carry the stigma of a criminal conviction.<sup>26</sup> Civil sanctions therefore provide additional options for policy makers seeking to strike a balance between deterring undesirable conduct and not deterring desirable conduct, while minimising overall enforcement costs.

2.28 The decision to designate a sanction as criminal or civil can effectively involve the choice between the greater prospects of a successful civil action against the greater impact of a successful criminal action.<sup>27</sup> Although the dollar value of civil pecuniary penalties can be more severe than criminal fines, the threat of a criminal conviction may still act as a greater deterrent. However, criminal sanctions are generally more difficult to secure, possibly because of the greater procedural protections for the defendant<sup>28</sup> or the higher burden of proof.

## Current status of civil sanctions in corporate law

2.29 Civil sanctions were introduced into the Corporations Law in 1993 for breaches of directors' duties, as the result of recommendations of the Senate Standing Committee on Legal and Constitutional Affairs (Cooney Committee). Prior to the introduction of civil sanctions, breaches of the directors' duty provisions were addressed solely by criminal sanctions.

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24 The Australian Law Reform Commission, *Principled Regulation Report: Federal Civil and Administrative Penalties in Australia*, December 2002, at paragraph 2.47.

25 Coffee, J, *Paradigms Lost: The Blurring of the Criminal and Civil Law Models – And What Can Be Done About It*, *Yale Law Journal* vol 101 at 1878.

26 The Australian Law Reform Commission, *Principled Regulation Report: Federal Civil and Administrative Penalties in Australia*, December 2002, at paragraph 2.60.

27 The Australian Law Reform Commission, *Principled Regulation Report: Federal Civil and Administrative Penalties in Australia*, December 2002, paragraph 3.69.

28 *ibid.*

- 2.30 In the course of its inquiry, the Cooney Committee heard evidence that the criminal penalties for breaches of directors' duties, often involving imprisonment, were too harsh. This made the courts reluctant to impose terms of imprisonment, and the modest fines that were imposed instead gave the appearance that the law was weak.<sup>29</sup> The Cooney Committee recommended that civil penalties should be used where misconduct fell short of a criminal offence and dishonesty or fraud was not an element of a contravention.<sup>30</sup> These recommendations were also applied to the provisions governing the obligation to prepare financial statements and directors' reports.
- 2.31 The introduction of civil sanctions into the Corporations Law allowed the regulator a greater range of options moving up the enforcement pyramid.<sup>31</sup> Civil sanctions were also seen as having the advantage of being a more powerful enforcement mechanism, due to the lower standard of proof required. Another reason for imposing civil rather than criminal sanctions included balancing the desire to protect the public without unduly burdening honest directors and deterring people from wanting to take on that role.<sup>32</sup>
- 2.32 The civil regime has been amended to broaden its application several times since 1993. Table 1 provides a timeline of amendments extending the system of civil sanctions from directors' duties to market misconduct provisions, including market manipulation and insider trading.

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29 Company Directors' Duties: Report on the Social and Fiduciary Duties and Obligations of Company Directors, Senate Standing Committee on Legal and Constitutional Affairs, November 1989 at paragraph 5.57.

30 *ibid.*, 188.

31 Gilligan, G, Bird, H and Ramsay, I *Regulating Directors' Duties – How Effective are the Civil Penalty Sanctions in the Australian Corporations Law?* (1999) Centre for Corporate Law and Securities Regulation, Melbourne, 8.

32 Gillooly, M and Wallace-Bruce, M 'Civil Penalties in Australian Legislation' (1994) 13(2) *University of Tasmania Law Review* 269,287.

Table 1: Timeline of amendments to the system of civil sanctions

Year introduced	Provisions	Reason for introduction
1993	Duty to act honestly Duty to exercise care and diligence Duty not to make improper use of information Duty not to make improper use of position Prohibition against insolvent trading Financial benefits to related party provisions Financial statements and directors' reports	Introduced as a consequence of the recommendations of the Cooney Committee that criminal sanctions should be reserved for contraventions where the conduct was genuinely criminal in nature and that civil penalties be available where no criminality was involved.  These provisions were previously subject only to criminal sanctions.
1998	Share capital transaction provisions	These provisions were previously subject only to criminal sanctions and also compensation orders.
1998	Duties imposed on those involved in the management of managed investment schemes	Introduced as a result of the Government's adoption of the recommendation of the report, <i>Collective Investments: Other People's Money</i> , <sup>33</sup> that the new duties proposed under the new managed investments scheme should also be subject to the civil penalty regime.
2001	Market misconduct provisions — continuous disclosure, market manipulation, false trading and market rigging, dissemination about an illegal transaction and insider trading	These provisions were previously only subject to criminal sanctions.  The deterrent effect of financial penalties would be enhanced by ASIC's capacity to take civil as well as criminal proceedings. <sup>34</sup>

## Proposed status of civil sanctions in corporate law

- 2.33 The decision as to whether civil, criminal or both sanctions should apply to an offence will reflect a judgement as to which combination will best further the policy objectives of the relevant regulation, while not unduly impairing the rights of the individual suspected of a contravention.
- 2.34 In the absence of intentional or reckless conduct, it may be difficult to argue that a contravention warrants a criminal sanction. As previously discussed, the current directors' duty provisions in corporate law recognise a difference between a breach that has an element of intent and one that does not by applying civil sanctions where there is an absence of intent.
- 2.35 Where it is considered that a criminal sanction is not warranted, because the wrongdoing is not 'serious' or 'substantial' in nature, it may be appropriate to consider the introduction of a civil sanction. If this model is followed, a number of offences (particularly strict liability offences) that are currently subject to criminal sanctions may instead become subject to civil pecuniary penalties.

## Magnitude of civil pecuniary penalties

- 2.36 As discussed above, where a Court is satisfied that a person has contravened a civil penalty provision, it must make a declaration of the contravention, and may also order payment of a pecuniary penalty, make a compensation order, or a banning order.

33 The Australian Law Reform Commission and The Companies and Securities Advisory Committee Report, Report no. 65, *Collective Investments: Other People's Money*, Commonwealth of Australia, 1993.

34 Department of the Treasury, *Corporate Disclosure: Strengthening the Financial Reporting Framework*.

- 2.37 It is proposed that this suite of sanctions would be retained for the current corporations/scheme civil penalty provisions.
- 2.38 Where an existing criminal strict liability offence is replaced with a civil offence, it is proposed that potential orders would be considered on a case by case basis. In many cases, it may be that it would be sufficient to limit potential orders to pecuniary penalties.
- 2.39 In this regard, it is noted that there has been some recent criticism of the magnitude of civil pecuniary penalties under corporate law. An example is found in the comments of His Honour Justice Finkelstein in *ASIC v Vizard*.<sup>35</sup> In discussing the imposition of a pecuniary penalty in respect of a contravention of section 183 of the Corporations Act, his Honour made comments about the importance of the section, not only because of its regulation of the potentially harmful consequences of the type of conduct (improper use of information), but also because it seeks to establish a norm of behaviour necessary for the proper conduct of commerce. In considering the maximum civil pecuniary penalty of \$200,000, His Honour stated that a contravention of the section 'holds great potential for profit' and may require review given that the amount has been in place for 13 years.
- 2.40 Other commentators have suggested a review of the civil penalty amounts is necessary to strengthen their deterrent value.<sup>36</sup> For example, the current maximum levels of penalty for a breach of the civil insider trading provision may be considered to be relatively low at \$200,000, given high potential profits from prohibited conduct and the fact that the courts have the discretion not to impose penalties at the maximum level.
- 2.41 For a penalty to be meaningful as a deterrent it must have an impact on the entity penalised. It can be argued that penalties imposed on corporations, especially pecuniary penalties, have the potential to be transferred by the corporation onto third parties such as shareholders, employees and consumers. This shift has been criticised as potentially lessening the deterrent value of corporate criminal liability.<sup>37</sup>
- 2.42 It should not always be assumed, however, that the imposition of a penalty on a corporation will only have a limited effect. The exposure of a company to a sufficiently substantial penalty may act as an incentive to directors and others to ensure that their company complies with regulatory provisions. Shareholders of a company that incurs a penalty may question whether the directors have properly carried out their duties to manage and control the company's affairs. If sufficiently concerned, shareholders could move for the dismissal of directors or even initiate derivative actions against them for breach of duty.<sup>38</sup>
- 2.43 If the maximum levels of penalty are considered too low, there are alternatives to simply increasing the maximum amount of the penalty. These alternatives may better

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35 [2005] FCA 1037 (28 July 2005).

36 Welsh, M, 'The Corporations Law Civil Penalty Provisions and the lessons that can be learnt from the *Trade Practices Act 1974*' (2000) 11(3) *Australian Journal of Corporate Law* 298.

37 The Australian Law Reform Commission, *Principled Regulation Report: Federal Civil and Administrative Penalties in Australia*, December 2002, paragraph 8.9.

38 Corporations and Markets Advisory Committee Report: *Personal Liability for Corporate Fault* September 2006. Derivative actions may be brought under sections 236-242 of the *Corporations Act 2001*.

reflect the gain that has resulted from a breach or the offender's capacity to pay a penalty. For example, recent amendments to the *Trade Practices Act 1974* will allow a pecuniary penalty of the greater of the maximum penalty or three times the gain from the contravention or, where gain cannot be readily ascertained, 10 per cent of the turnover of the body corporate and all of its interconnected bodies corporate.<sup>39</sup>

- 2.44 There has also been some discussion about the availability of alternative options to pecuniary penalty amounts. Recently, the ALRC has recommended a number of alternative sentencing options for Federal offences. These include orders disqualifying the corporation from undertaking certain commercial activities, corrective action within the organisation, activities for the benefit of the community, publication of offending conduct and dissolution of the corporation.<sup>40</sup> It should be noted that the impacts of some of these options, particularly orders dissolving the corporation, would be borne by shareholders, creditors, customers and employees of the corporation.
- 2.45 As discussed in the first section of this paper, any increase to the sanctions for misconduct would need to be considered in light of the potential freezing effect that this might have on responsible risk taking.

### Court procedure in civil actions

- 2.46 There has been a tendency for the courts to apply some procedural rules usually applicable to criminal proceedings in civil proceedings under corporate law. This trend may operate to undermine the rationale for introducing the civil penalty regime. Some commentators have suggested that greater certainty and reduction in delays and costs could be achieved if the law explicitly stated which rules are to apply.<sup>41</sup>
- 2.47 Section 1317L of the Corporations Act provides that a court must apply the rules of evidence and procedure for civil matters when hearing proceedings for a:
- declaration of contravention; or
  - pecuniary penalty order.
- 2.48 The meaning of the words 'rules of evidence and procedure for civil matters' is not clear on the face of the provision because there are a variety of civil evidence and procedural rules that can apply. This provides the courts with the flexibility to tailor proceedings in accordance with the nature of the order sought rather than by reference to whether the proceedings are characterised as either criminal or civil.<sup>42</sup> The High

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39 Trade Practices Legislation Amendment Bill (No. 1) 2005.

40 Australian Law Reform Commission Report 103, *Same Crime, Same Time: Sentencing of Federal Offenders*.

41 See for example, Middleton, T 'The Difficulties of Applying Civil Evidence and Procedure Rules in ASIC's Civil Penalty Proceedings under the Corporations Act' (2003) 21 C&SLJ 507; Rees A, 'Civil Penalties: Emphasising the adjective or the noun', loc cit.

42 This approach was adopted by the Queensland Court of Appeal in *Chief Executive Officer of Customs v Labrador Liquor Wholesalers Pty Ltd* (2001) 162 FLR 230.

Court, for example, has noted that section 1317L requires the court to apply the body of law developed in relation to the privileges against penalties and forfeiture.<sup>43</sup>

- 2.49 The ALRC has previously explored the procedural distinction between civil and criminal cases with a view to determining whether legislation should provide when heightened protection such as the Briginshaw standard should apply to cases that would otherwise be dealt with using civil procedures.<sup>44</sup> The rule in Briginshaw requires that if the civil standard is applied, the nature of the issue affects the process by which reasonable satisfaction is attained and exactness of proof is expected.
- 2.50 The ALRC noted that the application of civil procedure, unlike criminal procedure, varies from court to court on a case by case basis. Although this gives courts the ability to tailor their procedures to meet the demands of justice, it can and does introduce inconsistency in the way that different cases are viewed by different courts and judges.<sup>45</sup>
- 2.51 Arguments in favour of legislating for the procedure to be followed in civil cases, irrespective of the seriousness of a particular case, include that it would improve consistency and fairness. As the liberty of the subject is not at stake and the imposition of a civil penalty does not attract the stigma of a criminal conviction, the heightened protections embodied in the rules of criminal procedure are inappropriate and unnecessary.
- 2.52 Arguments in favour of the courts tailoring their approach on a case by case basis and sometimes following criminal procedure include that in some cases the punishment of a civil penalty can be as severe, or more severe than, a criminal penalty. It follows that the accused should, therefore, have all the protections available in criminal matters.
- 2.53 The ALRC concluded that, despite the reservations expressed by some regulators in submissions about the role of the courts in providing greater protections, the courts need to have the flexibility to ensure that there is procedural fairness in each case.<sup>46</sup>

## Administrative sanctions in corporate law

- 2.54 Criminal sanctions may not be an effective tool to deter or punish breaches of low-level reporting and record-keeping offences. The choice that an entity takes to comply with the law or not may be informed by the level of penalty that applies to a particular breach, the risk of being caught and thereafter the likelihood of successful prosecution. It may be the case in respect of these low-level offences that deterrence or punishment value is negated because of the relatively low likelihood of a criminal prosecution being instigated. These types of offences may, therefore, be suitable for the application of administrative sanctions.

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43 *Rich v ASIC* (2004) 220 CLR 129, however note also the 2005 announcement by the Parliamentary Secretary to the Treasurer that the privilege will be abrogated in relation to proceedings where ASIC is seeking disqualification or banning orders and no other penalty.

44 The Australian Law Reform Commission, Principled Regulation Report: *Federal Civil and Administrative Penalties in Australia*, December 2002, paragraph 3.64.

45 *ibid.*, paragraph 3.52.

46 *ibid.*, paragraph 3.67.

- 2.55 Administrative sanctions are imposed without the intervention of a court, but with the right of appeal to an independent tribunal or a court. For example, appeals concerning administrative penalties imposed under the *Taxation Administration Act 1953* are heard by the Administrative Appeals Tribunal (AAT) or the Federal Court.
- 2.56 The principal features of true administrative sanctions (as distinct from, for example, infringement notices)<sup>47</sup> is that they are of amounts that are pre-determined in the relevant legislation and are imposed by the regulator as a matter of law.<sup>48</sup> As such, they are not prosecuted within the court system.
- 2.57 Administrative sanctions have the following characteristics:
- the amount of the penalty is pre-determined by statute, according to a formula in the legislation and the legislation determines when a breach has occurred;
  - the regulator has no power to determine the level of the penalty before liability to pay the penalty arises, or to take extenuating circumstances into consideration;
  - the regulator has the ability to remit the penalty after it is imposed; and
  - a review and appeal mechanism on the merits to the regulator and the AAT, with appeals from the AAT to the Federal Court on questions of law.

### Rationale for the use of administrative sanctions generally

- 2.58 Administrative sanctions can reduce complexity in legislation by allowing:
- existing penalty provisions that have substantially the same operative effect to be grouped together; and
  - the same administrative penalty to be imposed for breaches of similar obligations.
- 2.59 The use of administrative sanctions can also keep the legal cost of enforcement at a minimum.<sup>49</sup> Criminal prosecutions are a resource intensive enforcement option for Government and defendants. Generally, if the cost of enforcement is high, regulators may only be able to pursue a selection of cases. In addition, some cases of regulatory non-compliance will not face sanctions at all because criminal prosecution may not be appropriate. If regulators have access to lower cost enforcement options, this can result in greater compliance.
- 2.60 Comparative studies of administrative and criminal enforcement processes in the United States and Canada demonstrate that, in a system with administrative sanctions, offenders are more likely to be identified and penalised than in a system relying solely

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47 The Australian Law Reform Commission in its 2002 report *Principled Regulation: Federal Civil and Administrative Penalties in Australia* states that infringement notice schemes are not true administrative penalties, but are administrative methods for dealing with certain breaches of the law.

48 For example, see Part 4-25 of the Schedule to the *Taxation Administration Act 1953*.

49 Regulatory Justice: Sanctioning in a Post-Hampton World, Consultation Document, May 2006, at paragraph 3.23.

on criminal prosecutions.<sup>50</sup> As a consequence, compliance is expected to be significantly higher in systems with administrative penalties than systems which rely on criminal sanctions. These comparative studies have identified a number of reasons why administrative sanctions are more effective in fostering compliance. These reasons are:

- they are more effective when operating in a risk-based regulatory environment. Regulatory non-compliance in a risk-based system is focussed on preventing harm rather than on the need for actual harm to occur. Criminal sanctions are normally more appropriate where there has been actual harm caused by regulatory non-compliance;
- administrative sanctions are less stigmatising than criminal sanctions;
- administrative procedures are less cumbersome than the more labour intensive criminal process; and
- administrative sanctions can be more proportionate. In an administrative system the level of penalties may better match the financial gain made by breaching regulatory obligations, and capture this financial benefit.<sup>51</sup>

2.61 For most small and relatively insignificant regulatory contraventions, the threat of an administrative penalty may provide sufficient incentive to comply with the law. However, some limitations of administrative sanctions should be noted:

- the low public profile of an administrative system means that costs arising from stigma and inferior market reputation are unlikely to be significant; and
- there are limits to the severity of an administrative charge. For example, a failure to keep or retain a record as required under a taxation law is subject to an administrative penalty of 20 penalty units (\$2,200).<sup>52</sup>

## Proposed status of administrative sanctions in corporate law

2.62 Administrative sanctions may be suited to minor breaches, involving strict or absolute liability, and no forensic inquiry. Possible examples include breaches of low level record keeping and reporting provisions in corporate law that are currently subject to criminal sanctions. These offences attract maximum pecuniary penalties of between five and twenty penalty units.<sup>53</sup> Some examples of these types of provisions are at Table 2.

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50 *ibid.*, at paragraph 3.24. The consultation document refers to studies conducted by Brown, R in 1992 and Brown, R and Rankin, M in 1990.

51 Regulatory Justice: Sanctioning in a Post-Hampton World, Consultation Document, May 2006, at paragraph 3.23.

52 *Taxation Administration Act 1953*, section 288-25.

53 Under section 1313, ASIC can issue a penalty notice in respect of a breach of offences that are subject to a maximum penalty of five penalty units under the Corporations Act, rather than bringing a prosecution. Payment of the prescribed penalty and remedying the contravention precludes criminal proceedings. The prescribed penalty is currently 1.25 penalty units for an individual and 6.25 penalty units for a body corporate (regulations 9.4.02 of the Corporations Regulations). It should be noted that penalty notices are

2.63 In these cases, a sanction is necessary to maintain the integrity of the system, but the element of moral wrongdoing in the case, or degree or nature of the breach, is insufficient to warrant criminal or civil proceedings.<sup>54</sup>

Table 2: Examples of low-level provisions — Corporations Act

Provision	Purpose	Penalty
Section 143	A company that does not occupy premises at the address of its registered office must be able to show ASIC the occupier's written consent to the company's use of those premises as its registered office.	5 penalty units (\$550)
Section 144	Company's name must be displayed at registered office — a company must display its name prominently at every place at which the company carries on business and is open to the public.	10 penalty units (\$1,100), or 3 months imprisonment, or both
Section 172	The address where a register is located, must be notified to ASIC within 7 days of the register being established or moved if the register is not located at the registered office or principal place of business of the company.	10 penalty units (\$1,100), or 3 months imprisonment, or both
Subsections 205B (1), (2), (4) and (5)	A company must notify ASIC of new directors or secretaries or change in details of directors etc within 28 days.	10 penalty units (\$1,100), or 3 months imprisonment, or both

## Consultation issues

### *Criminal sanctions*

Should criminal sanctions only apply where there is an effect or potential effect on the integrity of the market that warrants the severest condemnation or punishment, and/or where the market would expect an element of retribution, and/or where a breach is intentional or reckless?

Should strict liability offences be limited to situations where:

- the offence is not punishable by imprisonment and is punishable by a fine of up to 60 penalty units for an individual (300 for a body corporate);
- the punishment of offences not involving fault is likely to significantly enhance the effectiveness of the enforcement regime in deterring offences; or
- there are legitimate grounds for penalising persons lacking 'fault', for example because they will be placed on notice to guard against the possibility of any contravention?

Should imprisonment only be retained as a penalty for serious criminal offences with the maximum term being at least six months?

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an administrative alternative to prosecution and are not 'administrative sanctions' of the type discussed in this paper.

54 An example of an administrative penalty regime is contained in Part 4-25 of the Schedule to the *Taxation Administration Act 1953*.

## Consultation issues (continued)

### *Civil sanctions*

Should greater use be made of civil sanctions for breaches of corporate law?

If so, should civil sanctions apply:

- Where misconduct affects or potentially affects the integrity of the market, but there is an absence of intention in the conduct that makes the offence less egregious than an offence attracting a criminal sanction?
- Where strict liability applies to all elements of an offence?

Should there be an increase, or a reduction, in the amount of civil pecuniary penalties? If maximum pecuniary penalties are thought to be inadequate, would alternative options like those proposed for the *Trade Practices Act 1974* be appropriate in corporate law?

Should the rules of procedure to be adopted by the courts in civil proceedings under the Corporations Act be more clearly defined in the Act?

If rules were to be included in the Act, should they be the same as the rules followed in civil remedial actions or should they be some type of hybrid between criminal and civil procedure?

Are there any particular privileges available under the criminal law that should be abrogated in civil actions?

### *Administrative sanctions*

Do you agree that there is scope in corporate law for administrative sanctions to apply to breaches of low level record keeping and reporting provisions? Are there any types of misconduct within these low level offences that administrative sanctions should not apply to?



## CHAPTER 3: BETTER DEFINING THE CONTRAVENTION

### General protection for directors

- 3.1 The discussion in Chapter 1 highlighted the importance of achieving a balance between discouraging undesirable behaviour and ensuring business is willing to take sensible commercial risks. The discussion in Chapter 2 identified a number of options for reforms to the type of sanctions that may be imposed on a person for a breach, which might address this concern by providing more enforcement options lower down the 'enforcement pyramid'.
- 3.2 Another possible approach to alleviate concerns that some sanctions are adversely affecting directors' willingness to engage in responsible risk taking is to provide a consistent defence in the Corporations Act to relieve directors of liability for decisions made where they act:
- in a bona fide manner;
  - within the scope of the corporation's business;
  - reasonably and incidentally to the corporation's business; and
  - for the corporation's benefit.
- 3.3 Directors' duties in corporate law ensure their loyalty to the company. A director is said to be in a fiduciary, as opposed to an arm's length, relationship with the company. They are appointed to act for the company's benefit, but the nature of their position also allows them to act to its detriment. For example, directors may engage in self-dealing transactions which benefit themselves at the expense of the company. It is this type of situation which the duty of directors to act in the best interest of the company and the duty to avoid conflict of interest are designed to address. Another situation in which the interests of directors and shareholders may diverge is where directors act with insufficient care or diligence in relation to the affairs of the company. It is to this situation that the duties of care, skill and diligence are directed.<sup>1</sup>
- 3.4 Directors' duties must strike a balance between keeping directors accountable to the interest of the company and allowing them discretion to make decisions which may contain an element of risk. The introduction of a general defence could be considered if it was desirable to provide directors with additional certainty about the legality of their actions where they have satisfied specified criteria. One suggestion that has been made is that such a defence could assist in better focussing the attention of directors on advancing the interests of the company.
- 3.5 Submissions were previously sought on the merits of a general protection for directors and other officers in the Government's consultation paper, *Corporate and Financial*

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1 Austin, RP. Ford, HAJ. and Ramsay, IM. *Company Directors Principles of Law and Corporate Governance*, Butterworths, 2005.

*Services Regulations Review* (the CFSR review).<sup>2</sup> While some submissions unconditionally supported the proposal, others suggested that conditions should be placed on the protection. A small number of submissions opposed any extension of the protection beyond the existing business judgment rule in section 180, particularly in relation to the duty not to trade while insolvent.

- 3.6 It is noted that the application of a general defence may add to the degree of complexity and costs involved in prosecuting a breach of relevant provisions. This factor should be considered in light of any possible reforms to clarify the procedures to be followed in civil penalty actions under corporate law (discussed in Chapter 2) which, if progressed, may make the conduct of such proceedings more predictable and straightforward.

### The current statutory business judgment rule

- 3.7 A protection from liability – the business judgement rule – currently operates in relation to the statutory duty of care and diligence in section 180 of the Corporations Act and equivalent duties at common law and in equity. The rule provides a safe harbour for directors who make a business decision to take or not to take action in respect of a matter relevant to the business operations of the corporation (that is, a business judgment).<sup>3</sup>
- 3.8 The requirements for the current business judgment rule to apply to a particular business judgment include making the judgement for a proper purpose, not having a material personal interest in the subject matter of the judgment and having sufficient information about the subject matter of the judgment.<sup>4</sup>

### Application of a general defence

- 3.9 Submissions to the CFSR review in support of the introduction of a general defence emphasised the beneficial effect that a general protection would have on corporate decision making, by reducing the risk of liability where business decisions are made by directors that meet the proposed general criteria. These submissions suggest that such a reform has the potential to improve the balance between deterring wrongdoing and ensuring that directors are not unduly constrained in acting in the best interests of the company.
- 3.10 Generally, the submissions in support of the general defence focussed on its application to the ‘core’ duties in relation to good faith, care and diligence, use of position and use of information in sections 180-183 of the Corporations Act, and the duty to avoid insolvent trading in section 588G. These ‘core’ duties govern a broad range of conduct by company officers, and may raise questions of potential liability under a variety of fact scenarios.
- 3.11 The submissions in support of the general defence did not canvass its extension to those directors’ duties that are more ‘mechanical’ in nature. For example, the financial reporting obligations, where the scope of the duty is more narrow and the

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2 Corporations and Financial Services Regulation Review, Australian Government, April 2006.

3 *Corporations Act 2001*, subsection 180(3).

4 *Corporations Act 2001*, subsection 180(2).

requirements to avoid liability are relatively clear, are less likely to give rise to the types of concerns identified about compliance with the ‘core’ duties.

- 3.12 These submissions also focussed on the benefits of the general defence in relation to breaches of the civil penalty provisions. This focus reflects a view that the nature of the criteria for the general defence does not anticipate their availability where it has been shown that there was an intention to commit an offence, for example as required under section 184 of the Corporations Act. It may also reflect a view that there is a higher degree of uncertainty about whether a breach of a civil penalty provision may arise in relation to a business decision as these are strict liability provisions.

### Application of a general defence to the insolvent trading provisions

- 3.13 The insolvent trading provisions in the Corporations Act impose a duty on a director not to incur a debt at a time when there are reasonable grounds to believe that the company is insolvent or would become insolvent by incurring the debt.<sup>5</sup> The provisions are designed to protect creditors at a time when funds are at risk and under the management of directors pending liquidation, a return to solvency or the imposition of some alternative administration. A director may avoid liability by relying on one of the specific defences to insolvent trading.<sup>6</sup> These defences are aimed at assisting directors who have acted diligently and actively participated in the management of the company, but have not been able to prevent incurring the debt. The defences are:

- *reasonable grounds to expect solvency*: use of the word ‘expect’ implies a measure of confidence that the company is solvent. A director must have reasonable grounds for regarding it as likely that the company would have been able to pay its debts when they fell due;<sup>7</sup>
- *delegations and reliance on others*: a director must have had reasonable grounds to believe, and did believe, that a competent and reliable person was responsible for providing them with information about the company’s solvency, that the person was fulfilling their responsibility and expected on the basis of the information provided that the company was solvent and would remain so if the debt was incurred;<sup>8</sup>
- *absence from management*: a director did not participate in the management of the company at the time the debt was incurred because of illness or some other good reason. A director will not have a good reason for being absent from management merely by not participating in the company’s business;<sup>9</sup> and
- *all reasonable steps to prevent debt being incurred*: this may require unequivocal actions on the part of directors to exercise the powers and functions they possess

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5 Corporations Act 2001, section 588G.

6 Corporations Act 2001, section 588H.

7 *Metropolitan Fire Systems Pty Ltd v Miller* (1997) 23 ACSR 699.

8 *ibid.*

9 *Tourprint International Pty Ltd v Bott* (1999) 17 ACLC 1543.

to prevent the incurring of the debt directly or bring the matter to the attention of an officer or the board of directors.<sup>10</sup>

- 3.14 Some submissions to the CFSR review raised a concern that the general defence may be easier to establish and will therefore facilitate insolvent trading. Other submissions rejected this argument, suggesting that the general defence would be difficult to establish because a director would be expected to know when their company has reached or is nearing insolvency, or at least when they should seek expert assistance in relation to its financial standing. A director who continued to incur debts in the face of insolvency could not be said to be acting in a 'bona fide manner' or 'reasonably and incidentally to the corporation's business'.
- 3.15 Arguments about extending the general defence to the duty to prevent insolvent trading need to be considered in light of the possible unwillingness of directors to make business decisions as their company approaches insolvency. One viewpoint is that many directors who take risks when their company is close to financial insolvency do so in the genuine belief that by taking the appropriate investment or other decision, the company may be able to trade out of its financial difficulties<sup>11</sup> and should therefore have the benefit of additional legal protections. A contrary view is that the early transfer of control of a company to an external administrator will best protect the interests of creditors in these circumstances.

### Consultation issues

Do you consider that the introduction of a general defence would improve the balance between discouraging undesirable conduct and promoting responsible risk taking?

Do you consider that the proposed elements of the general defence are correct?

- Are there any particular concepts in the general defence that may require further consideration or elaboration?

Should the general defence apply to the 'core' duties in sections 180-183 and section 588G?

- Are there any adverse consequences that may result from a general protection applying to the duties of use of position (section 182) and use of information (section 183)?
- Would an extension of the general defence to the insolvent trading provisions encourage insolvent trading? Would an extension be to the detriment of creditors?
- If the general defence is applied to the duty to exercise care and diligence (section 180) is there a need to clarify its interaction with the business judgement rule in subsection 180(2)?
- If the general defence is applied to the insolvent trading provisions, is there a need to clarify its interaction with the existing defences?

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10 Lipton, P and Herzberg, A Understanding Company Law, Lawbook Co 2004 at p 370.

11 Baxt, B Insolvent trading – a possible new approach, available at [www.cch.com.au](http://www.cch.com.au).

**Consultation issues (continued)**

Should the general defence apply to those strict liability offences that are intended to protect shareholders interests?

The business judgment rule in subsection 180(2) also applies to equivalent duties at common law and in equity. Should a general defence also apply as a defence to actions brought in relation to equivalent duties at common law or equity?

## Inconsistent approach between sections 180 and 181

- 3.16 Section 181 applies an objective test of good faith. This means that conduct that is not objectively in the best interests of the corporation may contravene the duty of good faith, even if the company officer held a contrary belief.
- 3.17 A different test of good faith operates for the purposes of the business judgement rule. Specifically, subsection 180(2) provides a defence for company officers in relation to the duty of care and diligence, provided (inter alia) that they held a 'rational belief' that the judgement is in the best interests of the corporation. A belief that the judgment is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold.
- 3.18 Thus, two different tests currently apply to determine if directors have acted in the best interest of the company, for the purpose of satisfying their duties. Directors may comply with the requirements of the business judgment rule in subsection 180(2) by having the appropriate 'rational belief' that the business judgment is in the best interest of the corporation, yet could still breach the separate duty of good faith in section 181 by making decisions which, on a purely objective test, are not in the best interest of the corporation. This has the potential to introduce uncertainty about the situations in which a sanction may be imposed.

**Consultation issue**

Should the lack of symmetry between sections 180 and 181 on what constitutes acting 'in the best interests of the corporation' be addressed by introducing the concept of 'rational belief' to section 181?

## Review of section 189

- 3.19 Section 189 provides circumstances in which it is reasonable for company officers to rely on the advice of others. Specifically, section 189 provides that a directors' reliance on information or advice is taken to be reasonable if the reliance was made after making an independent assessment of information or advice.

- 3.20 When section 189 was introduced into the Corporations Law, the Government agreed to its amendment in the Senate to secure passage of the Bill.<sup>12</sup> Although extensive public consultation was conducted on the original provision, there was no opportunity for public consideration of the amended provision after its enactment.
- 3.21 The current formulation of section 189 is more robust than the original formulation, which provided that reliance would be reasonable after making proper inquiry if the circumstances indicated the need for inquiry. The original words were consistent with section 190 of the Corporations Act which provides that a director is not responsible for the actions of a delegate if, among other things the directors believed, after making proper inquiry that the delegate was reliable and competent in relation to the power delegated.
- 3.22 Section 189 is reproduced below. The original formulation of subparagraph (b)(ii) in the bill is indicated in square brackets.

189. If:

- (a) a director relies on information, or professional or expert advice, given or prepared by:
  - (i) an employee of the corporation whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned; or
  - (ii) a professional adviser or expert in relation to matters that the director believes on reasonable grounds to be within the person's professional or expert competence; or
  - (iii) another director or officer in relation to matters within the director's or officer's authority; or
  - (iv) a committee of directors on which the director did not serve in relation to matters within the committee's authority; and
- (b) the reliance was made:
  - (i) in good faith; and
  - (ii) [after making proper inquiry if the circumstances indicated the need for inquiry]after making an independent assessment of the information or advice, having regard to the director's knowledge of the corporation and the complexity of the structure and operations of the corporation; and
- (c) the reasonableness of the director's reliance on the information or advice arises in proceedings brought to determine whether a director has performed a duty under this part or an equivalent general law duty;

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12 Corporate Law Economic Reform Program Bill 1999.

the director's reliance on the information or advice is taken to be reasonable unless the contrary is proved.

- 3.23 It has been suggested that satisfaction of the requirement in subparagraph 189(b)(ii) may place an undue burden on persons seeking to rely on the provision. There are various ways that the requirement that directors make an 'independent assessment' of the information or advice that they receive. It could be interpreted to mean that each director must personally assess the information provided by others, but not seek external advice unless the circumstances are serious enough to require this. Alternatively the word 'independent' could be interpreted as requiring each director to obtain advice from a third party on the information received which may require a director, in some circumstances, to initiate a separate inquiry by a third party into information or advice received by that director.<sup>13</sup>
- 3.24 This provision received some consideration in the context of the Report on the failure of HIH.<sup>14</sup> His Honour Justice Owen noted that there are many factors that can be taken into account in deciding whether reliance is reasonable. They include:
- the nature of the functions delegated or in respect of which the information was given;
  - the nature of the transaction or event to which the information relates and, in particular, the risk that it involves; and
  - the relationship between the director and the provider of the information.
- 3.25 His Honour noted that perhaps the most important factor in deciding whether reliance is reasonable is the extent to which the director has made enquiries concerning the matter. More is required of a director than indifference. At the very least a director has the duty to be informed about the company's activities and financial position and a duty to make inquiries.
- 3.26 His Honour noted that there are two aspects to this. First, the facts of the particular episode may indicate the director was, or should have been, put on notice that inquiry was necessary. Second, if the director trusts someone, a question may arise as to what, if any, inquiries the director made to warrant the degree of trust place in that person.

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13 *ibid.*

14 Report of the Failure of HIH Insurance, volume 1, April 2003 at page 111.

### Consultation issues

Does the requirement to make an independent assessment of information or advice received, place too high a burden on directors?

Is the original formulation of subparagraph 189 (b)(ii) preferable to the current formulation?

## The obligation to keep financial records

- 3.27 In 2004, concerns were raised about allegations of poor record keeping in submissions made to the Parliamentary Joint Committee on Corporations and Financial Services inquiry into insolvency laws.<sup>15</sup> Some submissions to the inquiry commented on the poor state of record keeping amongst some companies exhibiting symptoms of financial distress. The Committee subsequently recommended that the Government review penalties attached to breaches of section 286 of the Corporations Act with a view to making them more effective as a deterrent.<sup>16</sup>
- 3.28 Section 286 provides that a company, registered scheme or disclosing entity must keep accurate financial records for a period of seven years that:
- correctly record and explain transactions and financial position and performance; and
  - would enable true and fair financial statements to be prepared and audited.
- 3.29 The maximum penalty for a breach of section 286 is 25 penalty units (\$2,750) or imprisonment for six months or both.
- 3.30 In reviewing the penalty for breach of section 286, consideration should be given to the fact that the Corporations Act also places a duty on directors and other officers to keep financial records. So, in addition to liability resting with the corporation for a failure to keep such records, a director of a company will be liable to a civil penalty if they fail to take reasonable steps to comply with or secure compliance with the obligation to keep financial records.<sup>17</sup> The maximum pecuniary penalty imposed in relation to this offence under section 344 is \$200,000. However, if the contravention is dishonest a director may be subject to a criminal penalty of 2,000 penalty units (\$220,000), or imprisonment for five years, or both.
- 3.31 One option to address the perceived inadequacy of the penalty under section 286 may be to increase the maximum penalty available in respect of a breach. It should be kept in mind, however, that at the time a breach is identified – usually when the company has been placed in external administration – there is little regulatory impact to be

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15 Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: a Stocktake*.

16 Parliamentary Joint Committee on Corporations and Financial Services, *Corporate Insolvency Laws: a Stocktake*, Report, June 2004.

17 *Corporations Act 2001*, subsection 344(1).

gained from prosecuting the company. Any increase to the magnitude of the penalty under section 286 would simply impose greater penalties on creditors.

### Consultation issues

Does the penalty for breach of section 286 provide an adequate deterrent?

Are there alternatives to pecuniary penalties that could apply to a contravention of section 286?

## Drafting of offence provisions

### Maximum penalties

- 3.32 Different styles of drafting offence provisions have been adopted in the Corporations Act in comparison to the *Australian Securities and Investments Commission Act 2001* (ASIC Act). For the most part, maximum penalties in respect of offences in the Corporations Act are set out in Schedule 3. In contrast, maximum penalties in the ASIC Act are either set out at the foot of the relevant provision or grouped in a separate provision within the relevant division.
- 3.33 A reader seeking to understand the effect of a particular offence provision in the Corporations Act has to look in the Act itself for the substance of the provision and then refer to Schedule 3 for the penalty. Some offences are not mentioned at all in Schedule 3 and the reader must then refer to the general penalty provisions to determine the applicable penalty.<sup>18</sup> Improved understanding and clarity of offence provisions in the Corporations Act may be achieved by repealing Schedule 3 and moving the maximum penalties for offences into the actual provision.

### Application of the Criminal Code

- 3.34 The *Criminal Code Act 1995* (the Criminal Code) applies to all offences that are included either in the Code itself, or in other Commonwealth legislation or common law. Its purpose is to codify the general principles of criminal responsibility under the laws of the Commonwealth. The Criminal Code is aimed at ensuring that the same principles of criminal responsibility will apply to all Commonwealth offences. It contains all the general principles of criminal responsibility that apply to any offence, irrespective of how the offence is created.
- 3.35 There may be provisions in the Corporations Act where the requirements of the Criminal Code are not strictly adhered to, for example, where the application of the fault elements and physical elements within an offence are inconsistent with the

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18 If an offence is not mentioned in Schedule 3 of the Corporations Act, the maximum penalty available is five penalty units (subsection 1311(5)).

Code.<sup>19</sup> Where this occurs the provision could be clarified to address any uncertainty about the way in which a court would apply the provision.

## Application of defences

- 3.36 The Criminal Code contains a number of defences of general application to Commonwealth offences. These defences are mistake or ignorance of fact<sup>20</sup>, ignorance of subordinate legislation that was not available<sup>21</sup>, claim of right over property (element relating to property)<sup>22</sup>, duress<sup>23</sup>, sudden or extraordinary emergency<sup>24</sup>, self-defence<sup>25</sup> and lawful authority.<sup>26</sup> Whilst the Code does not exclude the possibility that some offences may contain specific defences, additional defences should not be included unless the defences contained in the Code are inadequate.<sup>27</sup> Corporate law contains a number of offence provisions that allow a 'reasonable excuse' defence in respect of a breach. The Guide to Penalties recommends that this defence should not be used in Commonwealth offences as it is considered too open-ended and may create uncertainty for the prosecution as to the defence that may be raised.<sup>28</sup> Many of the exceptions to criminal responsibility thought to be caught by the 'reasonable excuse' defence (such as duress, mistake or ignorance of fact, intervening conduct or event and lawful authority) are covered by the generic defences in the Criminal Code.<sup>29</sup>
- 3.37 Some examples of provisions in the Corporations Act that allow a 'reasonable excuse' defence are sections 438B (duties of directors when administration begins) and section 475 (report as to company's affairs to be submitted to liquidator). As these offences are also strict liability offences, the defences of mistake of fact<sup>30</sup> and intervening conduct or event<sup>31</sup> are also available under the Criminal Code.

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19 For example, Chapter 2 of the *Criminal Code Act 1995* provides that recklessness can only be a fault element applicable to a physical element consisting of either a circumstance in which conduct occurs or a consequence of conduct.

20 *Criminal Code Act 1995*, section 9.1. This defence applies to fault elements other than negligence.

21 *Criminal Code Act 1995*, section 9.3.

22 *Criminal Code Act 1995*, section 9.5.

23 *Criminal Code Act 1995*, section 10.2.

24 *Criminal Code Act 1995*, section 10.3.

25 *Criminal Code Act 1995*, section 10.4.

26 *Criminal Code Act 1995*, section 10.5.

27 *A Guide to Framing Commonwealth Offences, Civil Penalties and Enforcement Powers*, Australian Government 2004.

28 *ibid.*, part 4.5.

29 *ibid.*

30 *Criminal Code Act 1995*, section 9.2.

31 *Criminal Code Act 1995*, section 10.1.

### Consultation issues

Would specifying the maximum penalty within a provision in the Corporations Act improve understanding and clarity of offence provisions?

Are there any provisions in corporate law where confusion is arising in the application of the provision because of inconsistency with requirements under the Criminal Code?

Are there any provisions in corporate law where confusion is arising because of 'reasonable excuse' defences, or other defences that replicate defences under the Criminal Code?

## Market manipulation and subsection 1041B(2)

- 3.38 Markets are potentially vulnerable to being deliberately misled and manipulated. Such acts are often easy to perpetrate, difficult to prove and can cause significant losses to others. They may also damage confidence in the markets concerned.
- 3.39 The law needs to take effective steps to protect the market. Requiring an intention to mislead or some lesser mental element, such as knowledge or recklessness, may create real practical difficulties in taking action against a defendant, since it is hard to prove a state of mind. On the other hand, there is an argument that a defendant should not be made guilty of a criminal offence where there is no such culpable mental element.
- 3.40 Section 1041B of the Corporations Act prohibits acts or omissions that have, or are likely to have, the effect of creating a false or misleading appearance, either of active trading in financial products on an Australian financial market or with respect to the market for or price of such products on such a market.
- 3.41 Subsection 1041B(2) is a deeming provision. Its effect, generally, is that a defendant is taken to have created a false or misleading appearance of active trading where the defendant acquires or disposes of financial products with no change of beneficial ownership, or makes matched orders to acquire and dispose of financial products. These categories of transaction are often entered into in order to manipulate the market.
- 3.42 There are concerns, however, that as a result of subsection 1041B(2), a defendant could incur civil and criminal liability for transactions that were entered into for legitimate purposes and did not create a false or misleading appearance.

### First issue: uncertainty as to current criminal liability

- 3.43 There is some uncertainty as to how subsection 1041B(2) and section 5.6 of the Criminal Code interact, and what their combined effect is.
- 3.44 Section 5.6 of the Criminal Code specifies the mental element needed for a defendant to be guilty of creating a result (in this case, creating a false or misleading appearance). The defendant must:

- intend the result;
  - be aware the result will exist in the ordinary course of events; or
  - be aware of a substantial risk that the result will occur and, having regard to the circumstances the defendant knows, it is unjustifiable to take the risk.
- 3.45 One view is that under subsection 1041B(2), a defendant would only be criminally liable if the defendant:
- intends a false or misleading appearance;
  - is aware that such an appearance will exist in the ordinary course of events; or
  - is aware of a substantial risk that the act will create a misleading appearance and, having regard to the circumstances the defendant knows, it is unjustifiable to take the risk.
- 3.46 The other view is that it is enough to establish criminal liability if the defendant intended or was aware or reckless that matched trades or a trade without change of beneficial ownership would occur.
- 3.47 An example of the different outcomes of these two views is the case of a defendant who sells a small parcel of shares at the end of the tax year purely to crystallise tax losses, then immediately buys them back at the same price. The transaction is not intended to create a misleading appearance and the market is not misled. If the second view is correct, the defendant would be deemed to have created a false or misleading appearance and would be criminally liable.
- 3.48 Another example would be a 'put through' transaction where financial products are transferred from one nominee to another, with each nominee holding on behalf of the same funds manager. In such a case there would be no change in the beneficial ownership of the products. Even if the transaction is conducted in accordance with market rules and if there is no risk of the market being misled, under the second view the defendant would be deemed to have created a false or misleading appearance and would be criminally liable.
- 3.49 The section could be rewritten to clarify what is required to establish criminal liability.

### Second issue: what mental element is appropriate to incur criminal liability?

- 3.50 As an alternative to the approach outlined above, subsection 1041B(2) could be amended such that, where the prosecution is relying on that provision for criminal liability, no intention, knowledge or recklessness as to the result of a defendant's actions would be required. Instead, it would be a defence in those circumstances if it is proved that the purpose or purposes for which the person did the act was not, or did not include, the purpose of creating a false or misleading appearance of active trading in particular financial products on a financial market. This defence would basically replicate that in subsection 998(6) of the old Corporations Law.

3.51 Possible concerns with this approach are:

- Using 'purpose' rather than intention as a criterion may create uncertainty and difficulties of proof. Commonwealth criminal law policy generally prefers to use the concept of intention, as defined in the Criminal Code, rather than purpose.
- It puts the legal onus of proof on to the defendant.
- If a defendant knew their actions would mislead, should they avoid liability because they had a different purpose?

### Third issue: liability to civil penalty under subsection 1041B(2)

3.52 Section 1041B is also a civil penalty provision. If ASIC applies for a declaration of contravention and the court is satisfied a person has contravened the section, then section 1317E provides that the court must make a declaration of contravention. In certain circumstances, a pecuniary penalty order or compensation order may be made against the defendant.

3.53 The imposition of such civil liability under the section could be changed. This might be achieved by creating a separate provision setting out the new rules for civil liability, or by adding to the existing section 1041B, which would still cover both civil and criminal liability.

3.54 There are two aspects that make it easier to incur civil than criminal liability under section 1041B.

- The civil standard of proof applies.
- A defendant can incur civil liability without any of the mental element required by the Criminal Code for criminal liability.

3.55 The section could be amended so that some mental element is required for civil liability. The law could be changed to provide that civil liability is incurred only where there is knowledge, intent or recklessness as to a false or misleading appearance. Alternatively, as was proposed in the case of criminal liability, it could be made a defence to civil liability if it is proved that the purpose or purposes for which the person did the act was not, or did not include, the purpose of creating a false or misleading appearance of active trading in particular financial products on a financial market.

3.56 A more restricted change would be to amend sections 1317E or 1317S, so that the court also had the discretion not to make a declaration of contravention, if it considered the defendant had acted honestly and ought fairly to be excused. This would be a more limited amendment, still leaving defendants potentially liable without fault and relying on the court's discretion.

### Consultation issues

Should section 1041B be amended to clarify the circumstances in which someone will be criminally liable, as a result of the combined effects of section 5.6 of the Criminal Code and the deeming provision in subsection 1041B(2) of the Corporations Act?

If so, would it be appropriate to amend the section so a person is criminally liable:

- if that person intended or was aware or was reckless that matched trades or a trade without change of beneficial ownership would occur; or
- if that person intended or was aware or reckless that a false or misleading appearance would occur?

Should there be a change to the circumstances in which criminal liability is incurred as a result of the application of subsection 1041B(2), so that a person is criminally liable without needing to prove any knowledge, intent or recklessness, but has a defence if it is proved that the purpose or purposes for which the person did the act was not, or did not include, the purpose of creating a false or misleading appearance of active trading in particular financial products on a financial market?

Should there be a change to the circumstances in which civil liability is incurred as a result of the application of subsection 1041B(2)?

If so, would it be appropriate that civil liability is incurred:

- if a person intended or was aware or reckless that matched trades or a trade without change of beneficial ownership would occur; or
- if a person intended or was aware or reckless that a false or misleading appearance would occur; or
- without needing to prove any mental element, as at present, but allowing a defence if it is proved that the purpose or purposes for which the person did the act was not, or did not include, the purpose of creating a false or misleading appearance of active trading in particular financial products on a financial market; or
- as now, but giving the Court the discretion not to make a declaration of contravention where a person has contravened section 1041B?

## CHAPTER 4: NEXT STEPS

- 4.1 This paper seeks comments on a number of issues relating to the regime of sanctions in corporate law. It is expected that a variety of viewpoints will be presented, reflecting different experiences with the broader regulatory framework. It is likely that additional issues will be identified, and linkages between issues further developed, in light of the comments received.
- 4.2 The closing date for submissions on this paper is 1 June 2007. It is expected that Treasury may seek further advice from contributors through a series of roundtables in July 2007, and provide a preliminary report to the Treasurer about the feedback received in August 2007.
- 4.3 An advisory group will then be established, to provide detailed advice on specific issues identified by the Treasurer as warranting further consideration and development. Treasury will provide a secretariat for the advisory group. The advisory group will comprise persons with knowledge or experience in a variety of fields including business, law and economics.
- 4.4 The work of the advisory group will form the basis of a proposals paper, presenting a detailed description of initiatives to improve the current regime of sanctions in corporate law. It is expected that the proposals paper will be provided to the Treasurer in November 2007.



# ATTACHMENT A

Excerpt from the report of the review on reducing regulatory burden on business, section 5 p 125

## **5.1 Financial and corporate regulation**

### **The regulatory approach**

#### **Achieving a balanced approach to regulation**

While business expressed concerns about the undue risk aversion of regulators, it was evident during the Taskforce's consultations that business has also been very risk averse in relation to matters subject to regulation. As for the regulators, the attitude to risk of regulated entities reflects the incentive structures they face. In part, this will reflect concerns about the potential damage to reputation that can occur if an enterprise is found to have breached its regulatory obligations.

Comments to the Taskforce indicated that the magnitude of penalties attaching to breaches of regulation have been a major driver of a regulated entity's approach to managing risks. For example, business groups noted that the personal liability attaching to a number of directors' duties had led to a very conservative approach by some directors to the detriment of business development.

While the Taskforce supports the deterrent value of penalties for breaches of regulatory obligations, it is important that the use of penalties strikes an appropriate balance between promoting good behaviour and ensuring business is willing to take sensible commercial risks. A risk-averse approach by business may limit their willingness to adopt innovative approaches in developing products and meeting new challenges. It would also be reflected in an overly cautious approach to compliance such as in product disclosure statements. This would undermine the overall efficiency and dynamism of the economy.

The Taskforce accordingly considers that there is considerable merit in reviewing the structure of penalties attaching to breaches of directors' duties to ensure that they achieve an appropriate balance.

#### **Recommendation 5.3**

The Australian Government should review the penalties for breaches of directors' duties to ensure that they strike an appropriate balance between promoting good behaviour and ensuring business is willing to take sensible commercial risks.